APPENDIX TO NOTICE OF
PUBLIC MEETING

California Department of Managed Health Care

PacifiCare of California's Notice of Material Modification Proposing an Indirect Change of Control that would result from a merger of PacifiCare Health Systems, Inc. into a UnitedHealth Group, Inc. subsidiary

September 16, 2005
10:00 A.M.

MEETING LOCATION
California Office of the Secretary of State, Auditorium
1500 11th Street
Sacramento, CA 95814

I. Introduction: Summary of Regulatory Authority of the Department of Managed Health Care

Under the Knox-Keene Health Care Service Plan Act of 1975 (Knox-Keene Act), the Department of Managed Health Care (DMHC) has broad power to regulate health plans and to ensure that the interests of enrollees are protected. To enforce the requirements of the Knox-Keene Act, the Director's powers include:

- Assisting, advising and cooperating with federal, state and local agencies to protect and promote the interests of enrollees, providers, plans and the public;
- Holding public meetings, issuing subpoenas to witnesses, taking testimony, compelling the production of books, papers, documents and other evidence;
- Licensing health plans by conducting prospective and retrospective review of plan policies and implementation thereof;
- Determining whether the investments of plan assets meet safeguards related to financial responsibility.

A plan obtains a Knox-Keene Act license by filing an application with the DMHC, detailing its general business and ownership structure, key officers, contracts with health care providers, proposed method of providing health care services (including physical facilities to ensure access to quality of care), intended service areas and product lines, and certified financial statements establishing the adequacy of reserves and integrity of claims payments. The DMHC's staff attorneys and financial analysts review the application and determine whether the plan meets Knox-Keene guidelines. If the plan's proposed business model meets the requirements for licensure, the Director grants a license and retains jurisdiction to regulate the health care service plan's actual operations.

A plan submits to the DMHC a "Notice of Material Modification" when it proposes a substantive change to its products, business structure, delivery model, administrative or provider contracts, or service area, or makes any other material change to its operations. The DMHC reviews the proposed changes to ensure that, post-transaction, the plan will remain compliant with all licensure requirements. Any proposed change of control, merger, or acquisition of a licensed health care service plan requires a Material Modification filing and requires the Department's approval before the transaction can close.

During the review process, the DMHC identifies specific issues that may negatively impact the delivery of health care services to California enrollees. Near the end of the process, the DMHC may develop written "undertakings" (mini-contracts) to help minimize the effect of any potentially negative outcomes. Undertakings memorialize the plan's promises offered as part of the Material Modification review process and are enforceable post-transaction.

The DMHC received a Notice of Material Modification from PacifiCare of California, Inc. (PacifiCare) on August 2, 2005, proposing a change in control of its parent company, PacifiCare Health Systems, Inc. (PHS) through a merger between PHS and a UnitedHealth Group, Inc. (United) subsidiary. PacifiCare of California is headquartered in California. United is a national health care company based in Minnesota, and owns insurance companies and HMOs across the country.

The DMHC received public comment on several merger-related issues at its recent meeting in Southern California. This second meeting is an opportunity to provide the public in Northern California an opportunity to comment on the effects of the proposed merger and for the health plans to respond to several issues raised at the first meeting.

II: Proposed Merger's Effect on Administrative Capacity and Costs, including claims payment, integration, and executive compensation

A plan must maintain the organizational and administrative capacity to timely provide basic health care services by having qualified medical providers render medical decisions unhindered by fiscal and administrative considerations. To facilitate compliance, the DMHC requires plans to maintain specific functions in California, including the medical director, who is responsible for monitoring the appropriate scope of clinical services, developing clinical policy, assisting in determining the plan's formularies, and overseeing the plan's prior authorization and referral process; the plan's grievance process (including Independent Medical Review); administration of the Provider Dispute Resolution Mechanism; and the maintenance of the plan's books and records.

A plan's operations, including administrative costs, must be fiscally sound. Administrative costs include salaries, bonuses, and benefits to officers, directors, or other principal managers, legal and accounting expenses and fees, and all other costs incurred in the operation of the plan that are not essential to the actual provision of health care services to enrollees. If a plan's administrative costs exceed 15 percent of its revenue for any reporting period, the DMHC requires the plan to demonstrate that administrative costs are not excessive and are justified under the circumstances. In addition, the DMHC must approve any administrative service arrangements that could result in unreasonable payments to the plan's parent, also called excessive "upstreaming."

PacifiCare and United represent that there will be no immediate integration of their administrative operations, but that integration possibilities will be examined in the future. United has purchased several health care companies in the recent past, but has not completed the large-scale integration of these companies.

PacifiCare has reported administrative costs-to-premium revenues between 8.9 percent and 11.72 percent in the years 2003 through 2005. In the most recently reported quarter, PacifiCare reported administrative costs-to-premium revenues as 9.26 percent.

Public reports show that United has had difficulty paying its provider claims in a timely manner, and the DMHC is concerned that United's poor practices will have a negative impact on PacifiCare's business processes.

III: Proposed Merger's Effect on the Financial Viability of a PacifiCare/United Combined Business Entity, including tangible net equity, cash flow, debt, and dividends

A fiscally sound plan maintains sufficient working capital, limits indebtedness, secures insurance, and maintains appropriate levels of Tangible Net Equity (TNE). A plan should not substitute long-term assets for liquid assets, which are necessary to timely reimburse provider claims and cover daily operating costs. A plan must also include provisions for contingencies, such as continuation of benefits to enrollees in the event of insolvency. Guaranteeing or assuming the financial obligations of an affiliate or declaring and distributing dividends to a parent company that can impair the ability of a health plan to meet its obligations are prohibited. Furthermore, adjusting the methodology for calculating reserves for the payment of incurred but not reported provider claims to meet TNE requirements can negatively impact a plan's fiscal soundness, and accordingly, this activity is restricted.

When a company purchases a California health plan, the DMHC must examine the purchaser's financial stability and commitment to developing California operations. In its review process, the DMHC examines the purchasing company's financial strength, looking particularly at net tangible assets and value of goodwill. The purchaser must demonstrate that it will not assume more debt than it can reasonably service and must provide projections demonstrating a reasonable likelihood that it will be able to timely pay all debt incurred to fund the transaction. The DMHC also examines a purchaser's explanation as to its ability and plans to pay debt gained by virtue of assuming the new licensee's debt, ensuring that the cost of a proposed transaction will not jeopardize the new subsidiary's financial stability.

The DMHC is particularly concerned with the financial relationship between the Knox-Keene licensee and its new parent post-transaction, examining whether the parent company will service acquired debt through dividends declared by the licensee that accumulated through California premium dollars.

PacifiCare of California has consistently maintained adequate tangible net equity levels, as required by the Knox-Keene Act. According to June 2005 quarterly public financial statements, United has negative $212,000,000 in net tangible assets, and PHS reported $843,603,000 in net tangible assets. United has indicated that it will fund the $8.1 billion acquisition price with a combination of cash and stock. The DMHC is concerned that the cost of this proposed merger might place the parent in a poor financial position and consequently risk enrollee protection.

During the first public meeting, the companies were asked to answer the following questions at the September meeting:

- Will the amount of negative tangible net equity that will be on the balance sheet of United, post-transaction, have a negative impact to the financial operations of United or any of its subsidiaries, including PacifiCare?
- Can United provide additional assurances that its cash flow will allow United to timely repay the transaction-related debt, as well as explain how the cash flows will remain at the current and projected levels?
- Can United provide detail as to the debt/equity structure, including how much debt will be incurred, the types of debt, equity issuance, and the cost of debt equity?
- Can United detail the amount of dividends that are projected to be paid out of California health plans, post-transaction?

Given the current situation in Louisiana and Mississippi, an additional question regarding financial viability has come to light:

- How has Hurricane Katrina financially impacted United's operations in Louisiana and Mississippi? Which companies have been financially impacted and how much?

IV: Proposed Merger's Effect on the California Health Care Market, including market consolidation and anti-competitive effects, commitment to the integrated model, and commitment to community

The DMHC evaluates a plan's operations for delivering health care services to enrollees by examining its business structure and processes, and by looking at the adequacy of its provider networks and hospital arrangements in its service area. The plan must establish procedures for providing its enrollees necessary care, and explain those procedures clearly to enrollees.

Over the past several years, health plan consolidation has been prevalent in California and across the country. This consolidation may have an impact on consumers' ability to gain access to affordable health plan products. The availability and affordability of these plans could similarly be enhanced or threatened by the further market consolidation caused by this merger.

PacifiCare of California sells a variety of commercial products and Medicare coverage across the state. In March 2005, PacifiCare reported 1,673,713 enrollees in California.

Most of PacifiCare's enrollment is in the large group commercial market, with 1,030,237 enrollees (about 62% of total PacifiCare of California enrollment). PacifiCare's Medicare Risk population is made up of approximately 360,000 enrollees. Small group enrollment in PacifiCare plans is approximately 150,000, and point-of-service enrollment is approximately 100,000. About 24,000 enrollees purchase PacifiCare's Individual coverage.

While United has no full-service HMO products in California since it exited the California HMO market in 2000, claiming that it did not have the infrastructure to maintain its California operations, PacifiCare's California infrastructure is substantial. United maintains that this purchase provides the necessary platform for reentering the California market. This purchase also appears to be consistent with United's recent national growth strategy, which has resulted in several health care company acquisitions across the country.

Both PHS and United have significant enrollment in their respective specialized plan affiliates. PHS has two specialized plan subsidiaries, PacifiCare Behavioral Health (PCBH) and PacifiCare Dental. PCBH has approximately 1.5 million enrollees in the Group market. PacifiCare Dental has approximately 326,000 enrollees in the Group, Medicare Risk, and Individual markets.

United has five Knox-Keene licensed specialized plan subsidiaries: US Behavioral Health; Dental Benefit Providers of California, Inc.; Pacific Union Dental, Inc.; Spectera Vision Services Plan; and ACN Group of California. Except for Spectera, which also offers individual products, these plans offer only group coverage. The total enrollment in these specialized plans is approximately 3 million Californians, with the highest enrollment in US Behavioral Health, at 2.4 million.

During the first public meeting, the companies were asked to answer the following questions at the September meeting:

- Can United quantify how PacifiCare's ability to access United's national network for its out-of-area and out-of-network medical services for enrollees will result in lower premium increases? Will the claimed network benefit result in a better rate for the PacifiCare enrollees?
- How will United and Pacificare's merger affect United's current business relationship with other Knox-Keene licensees?